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Quad/Graphics, Inc. (QUAD)

Q2 2023 Earnings Call

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Kevin Mark Steinke
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Quad's second quarter conference call. During today's call, all participants will be in a listen-only mode. [Operator Instructions] A slide presentation accompanies today's webcast and participants are invited to follow along advancing the slides themselves. To access the webcast, follow the instructions posted in the earnings release.

Alternatively, you can access the slide presentation on the investors section of Quad's website under the events and presentations link. After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Katy Krebsbach, Quad's Investor Relations Manager. Katie, please go ahead.

Katie Krebsbach

Manager-Investor Relations, Quad/Graphics, Inc.

Thank you, operator, and good morning, everyone. With me today are Joel Quadracci, Quad's Chairman, President and Chief Executive Officer; and Tony Staniak, Quad's Chief Financial Officer. Joel will lead today's call with a business update, and Tony will follow with a summary of Quad's second quarter and year-to-date 2023 financial results followed by Q&A.

I would like to remind everyone that this call is being webcast and forward-looking statements are subject to Safe Harbor provisions, as outlined in our quarterly news release and in today's slide presentation on slide 2. Quad's financial results are prepared in accordance with generally accepted accounting principles. However, this presentation also contains non-GAAP financial measures, including adjusted EBITDA; adjusted EBITDA margin; adjusted diluted earnings per share; free cash flow; net debt and debt leverage ratio.

We have included in the slide presentation reconciliations of these non-GAAP financial measures to GAAP financial measures. Finally, a replay of the call and the slide presentation will be available on the investor section of quad.com shortly after our call concludes today.

I will now hand over the call to Joel.

Joel Quadracci

Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Thank you, Katie and good morning, everyone. Beginning on slide 3, our second quarter 2023 results were in line with our expectations. Net sales were lower in the quarter compared to the same period in 2022, primarily due to lower paper and print sales as well as the 2022 divestiture of our Argentina print operations. We are pleased to have generated $34 million of free cash flow in the quarter, which we have used to further pay down debt, strengthen our balance sheet and return value to shareholders through additional share repurchases.

We are reaffirming our full year 2023 financial guidance, while some marketers have reduced print volumes due to economic uncertainty and postage rate increases. We continue to innovate solutions to help clients better manage cost, including our industry differentiating postage savings programs. For example, our unique merged mail solution combines multiple marketers direct mail piece production into a single run, delivering postage savings while maintaining content personalization.

Our DOORFRONT DIRECT solution provides an innovative alternative to the US Postal Service delivery bypassing the mailbox and delivering magazines, catalogs, direct mail and retail pieces directly to recipients' front doors. Our clients always have depended on our quality, on-time performance, and we have the right platform and expanded capabilities to fulfil our clients' print media and marketing needs as we enter the seasonally busier back half of the year.

As always and especially in the current economic environment we continue our longstanding disciplined approach to managing all aspects of our business, including treating all costs as variable and aligning our cost structure to revenue opportunities. At the same time, we continue to advance our unique offering as a marketing experience for MX Company that brings together all the resources, brands need for frictionless execution, as shown on slide 4. Further, our integrated marketing platform easily supports shifts in our clients marketing spend to maximize growth and results.

On slide 5, we show Quad's three growth drivers delivering integrated service excellence, accelerating market penetration and evolving our culture as an MX Company. Integrated service excellence is at the core of who we are and what we do.

Quad connects every facet of the marketing journey efficiently and at scale, providing innovative, data driven offerings from strategy and consulting to data and analytics, technology solutions, media services, creative and content solutions and managed services. As a result, we help companies reduce the complexities they experience from working with multiple agency partners and vendors, increase their marketing process efficiency and maximize the effectiveness of their marketing efforts.

We are continuing our partnership with Forrester Research, a leading global research and advisory firm, to better understand that the demand for holistic marketing solutions. At a time of accelerating marketing complexity, dwindling budgets and rising customer expectations of brands, through its serving of 355 marketing decision makers at mid to large sized US companies, Forrester confirmed and quantified brand's ongoing need to deliver growth with either – even fewer resources and greater results.

While 75% of brands have started consolidating some services their efforts are keeping pace with the expanding complexity, resulting in disconnected teams and workflows, wasted time and money and missed customer opportunities. Forrester's findings further validate a multi-year transformation to an MX Company that makes the marketer's job easier through an efficient and effective platform built for integrated execution.

Turning to slide 6, we continue to evolve how we communicate our value to accelerate market penetration. We launched a new brand campaign in the second quarter called Built on Quad, which is giving us wider visibility within our current client base as well as with companies in our targeted growth verticals.

We debuted the campaign in June in conjunction with the Cannes Lions International Festival of Creativity, the premier gathering of the global advertising and creative communications industry. While we – at Cannes, we shared our innovative story and strengthened relationships with marketing decision makers from around the world who are looking for scalable solutions to help drive the brand's growth. Our uniqueness as an MX Company resonates with brands and marketers because we provide a better market experience for our clients, they can focus on delivering the best customer experience.

Turning to slide 7, we showed how we were growing our presence with well-known brands in our targeted verticals of consumer packaged goods; finance and insurance; health direct to consumer retail and publishing. These well-respected and well-known brands include Red Bull, Sirius XM, Albertsons and CVS Health and are all admired for their excellence in the loyalty, they've built with our customers. We take great pride in knowing they can trust us to help unlock their marketing's full potential.

On slide 8, we show an example of how consumer packaged goods company Nielsen-Massey Vanillas is taking advantage of our integrated marketing offering. They chose to partner with Quad due to our great reputation for delivering breakthrough, creative and brand growth in saturated markets, especially in CPG categories, along with our robust data insights and media capabilities.

As the creative agency of record, we are now providing brand strategy, creative and campaign development, media, social and more to build awareness and loyalty among home cooks as well as professional chefs.

We're also helping the client to reach its most compatible customers by our award-winning cross-channel shopper targeting approach, as well as managing immediate planning and buying. Work for Nielsen-Massey Vanillas is underway and will be launched in the fourth quarter of this year. This is yet another example of how we are creating a better way for our clients through our reimagined marketing experience that is more streamlined, impactful, flexible and frictionless.

On slide 9, we show another example of how we help clients build better marketing. In this instance, how we created a consumer brand from inception, including a product launch at select Costco warehouse stores this summer. Our client created an innovative freeze-dried, raw superfood for dogs. We not only helped our client position and name its brand Heckova! but use the power of the integrated solutions offering to deliver eye catching packaging and promotion. We drew on our deep expertise in consumer research, design strategy, packaging, experiential and adaptive design, content services and retail environments.

We also seamlessly incorporated the services of our own photo studios, including digital creative, designed and printed the packaging and the in-store look for the product, stood up an appealing and interactive website and provided comprehensive marketing services, including promotional campaigns for digital and social channels and engaging social media influencers. The client is thrilled with our efforts and the speed and ease with which we help them launch a brand.

In fact, our client told us numerous times that they never could have gotten the product launched, sat on store shelves and promoted in the span of 10 months, had they not worked with Quad. We continue to be a trusted partner to Heckova! supporting our efforts to launch additional superfoods and providing campaign work as they expand the retail footprint and begin direct-to-consumer sales this fall. The client also will engage our packaged insight team for brand packaged performance research using the latest in biometric technology such as mobile eye tracking.

Turning to slide 10. Even as we expand into growing areas of the marketing experience, printing continues to be a core part of our business and a clear and competitive differentiator from traditional agencies. Our reputation for quality, on-time production, ongoing investments in automation and equipment and well-trained skilled workforce enables us to continue to gain segment share across all categories of print.

Recently, we expanded our print relationship with AARP, the organization that delivers information, the advocacy and service to people age 50 and older. Under a new multi-year contract, we are now the exclusive partner of the AARP Bulletin and AARP Magazine, two of the largest circulation publications in the United States. For years, AARP has trusted Quad for production of its direct mail advocacy program, along with our postage-saving, commingling services and logistics expertise.

We will begin production on these two publications in August and September, respectively. Additionally, AARP has engaged us for free press services, including paid processing and proofing, image retouching and archiving; ad traffic management, mailing list management and distribution to US Postal Service processing facilities for expedited in-home delivery.

AARP also will leverage two of our proprietary Software-as-a-Service workflow solutions, Publisher's Studio for issue mapping and AdShuttle for streamlining the planning, receipt and execution for the advertising. Our excellent track record with this company's direct marketing campaigns combined with our commitment to continuous innovation and our industry standing as a strong, stable provider – cemented this client expansion win.

Before I turn the call over to Tony, I would like to thank our employees for the continued hard work and daily commitment to providing the highest levels of service for our clients while we proactively manage all aspects of our business for long-term strength and stability. I regularly receive feedback from clients who share their deep appreciation for our team of innovators and problem solvers.

As we move forward with our growth strategy, I have great confidence in our team. We will continue to capitalize on all aspects of our distinctive maker culture to differentiate Quad is the workplace for the marketing industry's best talent. We also will continue to innovate the ways we attract talent. For example, last month, we unveiled a new recruiting and training hub in Milwaukee, Central City, as shown on slide 11.

This hub known as Quad MKE, is focused on removing barriers to the family sustaining careers by providing the tools, training and transportation necessary to attract individuals looking to improve their employment situation. Quad MKE is an important way to tangibly show our commitment to the community, and it's consistent with our values, especially that of believing in people.

With that, I will now turn over the call to Tony for the financial review.

Anthony C. Staniak

Chief Financial Officer, Quad/Graphics, Inc.

Thanks, Joel, and good morning, everyone. On slide 12, we show our diverse revenue mix. Net sales were $703 million in the second quarter of 2023, a 7% decline compared to the second quarter of 2022. The first half of 2023 net sales were $1.5 billion, a decline of 2% compared to the first half of 2022. Well, within our financial guidance, with sales growth in our Mexico operations and in our catalog packaging and in-store offerings more than offset by lower print and paper sales, primarily in direct mail as well as reduced sales from the December 2022 divestiture of our Argentina operations.

Slide 13 provides a snapshot of our second quarter 2023 financial results. Adjusted EBITDA was $50 million in the second quarter of 2023, as compared to $56 million in the second quarter of 2022. An adjusted EBITDA margin declined slightly to 7.2% in the second quarter of 2023 compared to 7.4% in the second quarter of 2022.

The decline was due to lower sales, partially offset by benefits from improved manufacturing productivity and savings from cost reduction initiatives. In the first half of 2023, adjusted EBITDA was $111 million compared to $105 million in the first half of 2022. And adjusted EBITDA margin improved from 7.0% to 7.5% consistent with our long term focus on increasing profitability.

Adjusted diluted earnings per share was $0.02 in the second quarter of 2023 as compared to $0.13 in the second quarter of 2022. Year-to-date, adjusted diluted earnings per share was consistent at $0.17. The decline in the second quarter was primarily due to lower adjusted net earnings and was partially offset by the positive impact from share repurchases. We were active in the market again this quarter, repurchasing our Class A shares. Beginning in the second quarter of 2022, we have repurchased approximately 8% of our total Class A and B outstanding common stock at a weighted average price of $3.32 per share for a total purchase price of $15 million.

Free cash flow was negative $45 million in the first half of 2023, a $12 million improvement compared to the first half of 2022 primarily attributable to lower inventory needs as supply chain challenges improved and we experienced strong receivables collections. This improvement was achieved despite a $12 million increase in capital expenditures as we continue to invest in our automation initiatives. As a reminder, the company historically generates the majority of its free cash flow in the fourth quarter of the year and expects $50 million to $90 million of free cash flow in 2023.

Slide 14 includes a summary about debt capital structure. Net debt increased by $59 million to $604 million at June 30, 2023, as compared to $545 million at December 31, 2022. And the debt leverage ratio increased 18 basis points to 2.34 times at the end of the second quarter 2023. Increase in net debt and the debt leverage ratio was primarily due to the negative $45 million of free cash flow in the first half of 2023.

However, we are pleased to have reduced debt by $80 million over the last 12 months. Debt will increase in the third quarter due to higher working capital requirements as we enter our production peak from August through October and then it will decline in the fourth quarter with seasonal reduction of inventory and collections of receivables. We are on track to achieve the low end of our long term targeted debt leverage range of 2 times to 2.5 times by the end of 2023.

As of June 30, our blended interest rate was 6.7%, which is up from 3.8% a year ago. To mitigate the impact of the rising interest rate environment, we entered into two interest rate collar agreements effective January 1, 2023, including interest rate swaps, our debt is 52% floating and 48% fixed. We maintained our strong liquidity with up to $340 million of availability under our revolving credit agreement as well as $11 million of cash on hand. Our near significant debt maturity is $88 million occurring in January 2024, which we will fund with cash on hand in our revolving credit agreement.

The majority of the debt maturities are not due until late 2026. We have reaffirmed our 2023 guidance as shown on slide 15. We are progressing on our growth strategy as clients continue to embrace our innovative and integrated marketing offering. However, as we discussed last quarter, due to ongoing macroeconomic concerns and increasing postage rates, we expect to continue to expect lower print volumes during the remainder of the year.

As a reminder, adjusted and free cash flow will be higher in the second half of 2023 compared to the first half of 2023 due to the seasonality of the business. Most of our capital expenditures already occurred in the first half of this year. So we can benefit from these investments in the second half of the year during our seasonal peak.

Slide 16 includes our key investment highlights as we continue to build on our growth momentum as a marketing experience company. We believe that Quad is compelling long term investment and we remain focused on growing net sales and driving higher profitability to continue diversification of our revenue and clients. With our expanded offerings, there is a significant addressable revenue opportunity. With both our large base of existing clients as well as new clients.

We will reduce debt with strong free cash flow generation augmented with proceeds from selling non-core assets. We expect to achieve the low end of our long-term target leverage rates up 2 times to 2.5 times, with net debt of approximately $470 million by the end of the year. This will represent a $564 million or 55% reduction in debt since January 1, 2020, when our debt was over $1 billion.

And with a significant debt reduction, we will further strengthen what we believe is an industry leading financial foundation that provides us the flexibility to strategically deploy capital, including scaling the growing parts of our business while returning capital to shareholders to drive shareholder value.

With that, I'd like to turn the call back to our operator for questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question comes from Kevin Steinke with Barrington Research Associates. Please go ahead.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.

Q

Hi. Good morning, everyone.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Good morning Kevin.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.

Q

Good morning. I wanted to start off by asking about just the seasonal pattern of sales, as you know, as it relates to the second quarter? And then also how you expect the second half to play out and maybe how any segment share gains or new business wins might play into your outlook for the second?

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Sure, Kevin and I think as we put out guidance earlier in the year, we had seen as our customers put forth their budgets. There was definitely some trepidation about economic concerns. And the other thing that somewhat impacted volumes for the year was a known significant postal increase that just happened a couple of weeks ago. And so oftentimes our clients, look at that and in the short-term, we'll do a little bit of pullback.

That being said, I'd say, we always talk about large-scale print, which encompasses retail inserts and publications as our biggest declining area. Quite frankly, year-to-date, that was virtually flat. Certainly decline in retail inserts as we always expect and some closures in the publication side, but also offset by some segment share gains.

And then in the targeted print, which is early catalogs, direct mail packaging and in-store, catalogs, again impacted by some of the trepidation was about flat year to date with – because of some volume pullback, but also some segment share wins offsetting that. And direct mail, I'd say is probably the one that was the most challenged. So year-to-date, it's off about 19%.

But that's strongly due to the fact that we have some significant exposure in the financial and loan vertical that was heavily impacted by the drastic increase in interest rates as well as one large client – banking client that pulled out of the consumer banking business. We expect direct mail though in the long term continue to be a great growth opportunity. And then on the bright side, packaging was up 4% year-to-date. In-store, which is a vastly growing [ph] marketplace continued that for us of up 17% (00:22:55). And agency relatively flat for the year impacted by some of the economic concerns.

But I think it's important to remember to your point about seasonality. The first half is the lowest part of our year with the second quarter being [indiscernible] (00:23:12) bottom of the year with everything now starting actually this week becoming our busy season. And we alluded to segment share gains that are happening in the future here with what we spoke about AARP, which is in publication space. But we expect several other things to kick in as a result of that. And so again, I think you really look at the full year and how that – those trends will play out. And we feel good about the guidance we have given on the top line based on what we saw our clients doing. Tony, am I missing anything?

Anthony C. Staniak
Chief Financial Officer, Quad/Graphics, Inc.

A

No, no. I think if I just expand on it for earnings a little bit, we take actions in the first half of the year, whether those be restructuring actions to get our cost structure where we want it to be or CapEx from a cash perspective where we do the majority in the first half of the year, that all positions us for a great second half of the year as the volumes increase, we are ready for those volumes.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.

Q

Okay. Great. That's very helpful. And Tony, you mentioned there the cost actions and can you just speak to what you've accomplished in the first half of the year here and maybe how we should think about expenses trending in the second half of the year?

Anthony C. Staniak
Chief Financial Officer, Quad/Graphics, Inc.

A

Yeah. I mean, we did close some capacity in the first half like we announced three plant closures that we completed in the first half of the year, that puts our capacity right where we needed to be as we enter busy season to keep our on-time deliveries high and meet customer needs. We always look at the administrative side of the house to make sure that whereas efficient as we can be to remain the low cost provider and all of that I think positions us well for a second half. From the restructuring standpoint, the majority of the cash payments have been in the first half of the year. And so you'll see less of that as we go into the second half, which will help free cash flow metrics.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

And just to add to that, on the manufacturing side, which is a huge platform, the productivity that we've been able to achieve is pretty massive this year. And that's because in the previous years when everyone was struggling to find people, we really double down on hiring and really double down on advanced training and really training up a significant number of people. And so as we saw of the economies just sort of slow down happened while we had to do some reductions.

The percentage that we're much more trained than in the past has resulted in wonderful productivity. And I can't tell you how proud I am of – enough about how the team has performed. And that's really important because now the ramp-up is really significant in the second half, which gives us that operating leverage because you've got fully trained people versus one you're trying to bring on people and they're not trained on very complicated equipment.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.

Q

Okay. Great. And you did mention, there the postage rate increases as an additional factor, leading to some pullback in print spend. But you also alluded to the fact that that's usually short-term impact. So would you expect clients to adjust to that over time? And you also mentioned your solution to bypass the US Postal Service. I mean, is that something that can gain more traction going forward as well?

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.
A

Yeah, you remember that postage is like over 70% of there is – of the cost to get mail into the consumer's hands now. And we wish that the post office would take a different tack, but it is what it is. And it's really incumbent upon the printer to try and offset those increases through work sharing programs with the post office allows us to do. In other words, the more we skip the post office, the bigger the discount. And a lot of our preferences about some of the products we do has helped our clients over time do that.

In addition, we're rolling out some new concepts that will further help offset fairly, significantly, some of the postage costs will be increased. So while they pull back in the short term, they still have the market product. And typically, they're trying to adjust their budgets for the increased spend, but we do as much as we can on the innovation side to kick in and try and help offset that decline. And so we feel good about what we're going to be able to do for our clients. But postage increases will continue to be a concern. But that's nothing new in the last 20 years.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.
Q

Okay, understood. Yeah. Can you just speak to the progress you made in the quarter on inventory reduction and free cash flow generation? You had $34 million of free cash flow in the second quarter, which was really significant uptick over the year ago quarter. So maybe just speak to that a little bit more, if you could?

Anthony C. Staniak
Chief Financial Officer, Quad/Graphics, Inc.
A

Thanks, Kevin. I mean, we were happy with the free cash flow we produced in the second quarter and that positive $34 million you mentioned, we were able to reduce inventory levels. The supply chain environment is easier than what we saw last year. I still won't say it's completely easy, but it has eased some. And that is allowed us with a very conscious action on our part to make sure that we're having paper levels and other inventory levels at the right quantities into realize that, that benefit for free cash flow. Also, we've been very focused on receivables, collections and our portfolios in great shape and that is also coming through the free cash flow.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.
Q

Okay. I'll ask one last one here and then jump back in the queue. But just also can you speak to your priorities with capital allocation? You continue to do a good job of reducing leverage year-over-year, and you're also starting to buyback shares. So how do you think about the mix? I know you have a target of 2.0 leverage by the end of the year. Do you expect you'll continue to look for opportunities to repurchase shares as well?

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.
A

Yeah. I mean, look that's been a long term strategy of really being disciplined about how we work with our capital allocation. And clearly, the priority since 2019 was to really focus on debt pay down, which we've done massively regardless of pandemics hitting us and affecting the whole world. And so very proud of that because we did that while still investing appropriately in the platform on the print side as well as in innovation.

But yeah, we saw the trajectory this year and felt very comfortable with starting stock buybacks. And as Tony said, since last year, we bought back about [ph] 80% (00:30:16) of the company for a pretty cheap price in our estimation. And we'll continue to look at those opportunities. And at some point we'd love to – we look at the possibility of some sort of sustainable dividend, but that's something the board will review at year end, which we do every year.

And so, I think you'll continue to see us be disciplined there. Debt will continue to be a good focus. But also we feel that with what we're doing and the transformation of this company and the scaling of what we have, that – it's a good investment to continue to look at buying back stock where the opportunity arises.

Kevin Mark Steinke
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thank you for taking the questions.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

A

Thank you, Kevin. Operator?

Operator: This concludes our question and answer session. I would like to turn the conference back over to Joel Quadracci for any closing remarks.

Joel Quadracci
Chairman, President & Chief Executive Officer, Quad/Graphics, Inc.

Great. Thank you, operator and thank you, everyone, for joining today's call. I just want to close by iterating my confidence in the team in our strategy and our future as a market experienced company. Our integrated marketing offering continues to be a competitive differentiator and a key driver behind our company's overall organic growth. At the same time, we'll continue to manage for the times, both financially and as well as creating shareholder value. And so with that, thank you again. Have a good day. We'll look forward to speaking to you again next quarter.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.